

Investment Errors and National Security

By
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The article [*The 10 Mistakes Investors Most Commonly Make*](#), featuring finance professor Meir Statman, has a number of observations that map right into national security issues. Basically, Statman suggests many of us--the investors he's talking about--have thought and behavioral pattern errors that don't always well serve our long-term financial interests. I'll accept Statman's basic thesis and will suggest these same errors affect our lives in many ways, including our work. For those working in national security, the consequences of these errors can be especially profound.

While some of Statman's investment errors overlap and others are somewhat paradoxical, I think they are largely representative of the challenges facing our national security policies, strategies, and investments. So, here are seven of Statman's top ten investment errors along with my take on how they impact national security:

1. **Hindsight errors** are made because investors can clearly see the past and they may think they have the same ability to look into the future. The reality is our ability to predict the future is pathetically inept, unless your predictions are sufficiently vague so as to be useless (see Nostradamus) or are out-and-out forehead slappers ("The sun will come up tomorrow").

What are the national security implications of hindsight error? Basically, hindsight error makes us think we understand the security challenges of the future. The reality is we need to prudently prepare and balance national security risks and costs because it is impossible to understand, prepare for, and fund for all the things that *might* happen. In a move away from hindsight error, consider the increasing visibility of a long unbroachable subject, [civil defense](#). While a nuclear attack is a low-probability event, civil defense has nearly zero cost (by governmental standards) but could help save countless lives.

2. **Unrealistic optimism**, which Statman says is loosely related to overconfidence and can lead to an overinflated and unrealistic opinion of one's investing abilities. While most of your neighbors will likely avoid laying claim to knowing what the markets will do, try finding someone on TV who *doesn't* know (and while you're at it, try to find a person who thinks they are a below average driver).

Healthy skepticism is the antidote to unrealistic optimism. From a national security point of view, consider the many major weapons system programs pursued using congenitally flawed government acquisition methods. These methods--and over optimism--have helped build whole families of programs which fail to meet performance, cost, and schedule goals. Did DoD go into Program X thinking it would be almost 400% over cost and a decade late to need? Of course not, but optimism, it must be then said, is clearly not a strategy. Thoughtful diligence (featuring full and vigorous debate), preparation, and monitoring are likely to provide far better outcomes.

3. **Extrapolation errors** happen when people expect past trends to continue into the future. For example, "The cost of oil has gone up for the last two years so it's going to keep going up." The reality is the price of oil fluctuates greatly based on supply, demand, the value of the dollar, and uncertainty. Oil, like markets in general, goes up and down. While the long-term oil trend line may indeed be up, we almost always fill up our vehicles one tank at a time and our minds tend to provide inordinate credit to things which have happened more recently.

The national security implications of extrapolation errors are evident in the long history of flawed conclusions like: the Soviet Union will stand forever; the post-Cold War period will be an enduring time of American hegemony; Iran has given up its nuclear weapons program; space is a sanctuary; and, the wars we're fighting now will be like the wars we fight in the future. It seems actual events can change much more quickly than our own mental models.

4. **Framing errors.** Statman offers that some people don't think successful investing is really all that hard. Similarly, basketball isn't that hard when you're shooting baskets by yourself in the driveway, but try playing against real basketball players in a real game. There, competitors use fakes, feints, screens, and misdirection in an attempt to outperform you. In addition, competitors are disinclined to give away uncontested shots.

By analogy, the national security implications of framing errors show that while empty gyms are pretty predictable, rivals are not. Sometimes the players on your own team change and there may be rules changes, unpredictable referees, or having to play away from one's home court. While the basket seldom moves to try to trick you, competitors will.

5. **Confirmation errors.** Investors often look for information that confirms their hypothesis and ignore (or explains away) contradictory evidence. For example, dedicated gold investors view gold as a good bet against inflation and a declining dollar. However, when confronted with [the evidence that gold prices actually trended down strongly](#) starting in the 1980s, throughout the 1990s, and even into the early years of this

millennium, that lesson is dismissed as ‘one from a bygone era’ with ‘an investing environment that’s since changed.’

What’s really changed recently--since about 2002--is gold’s price increase. So perhaps a more pertinent question is instead “How will prices change in the future?” From a national security point of view, the wars we’ve been in--since about 2002--have been much different from what we’d spent the decades before doing. That doesn’t mean we were wrong in focusing so much of our talent and treasure on the Cold War threat, but it does mean we ignore an ever changing world at our own peril.

6. **Fear**, which is the flip side of exuberance. Statman points out that when you're afraid, it’s much easier to view everything as a threat to your investment goals. Many individual investors have “gone to cash” as a result of fear or uncertainty. Similarly, a lot has been written about U.S. companies sitting on large cash reserves because they’re worried about the general business environment to include taxes, regulation, employee benefits, and more.

An excessively fearful national security perspective could result in an inordinate focus on clinging to the status quo which might mean lost opportunities for security improvements, including cost savings and investment redirects. With the uncertainty surrounding the global economy and fears of increasing government debt, non-U.S. NATO nations are certain to reduce their own defense investments and capabilities. This actually provides the U.S. an opportunity to address the huge issue of NATO free-ridership and conversely, might provide us chances to partner with other nations (say India) for a more beneficial security effect.

7. The **affinity of groups error** sometimes known as herding. When your spouse told you in 1999 that junior’s orthodontist was all-in on this dot com thing, or when an entire television network appeared in 2004 dedicated to the concept of buying and flipping houses, did these influence your investment thinking in any way? While either of those investments might have made lots of money (depending on when the investor got in or got out), both events also had the potential to--and did--create great financial losses.

When we allow our national security thinking to run with the herd, we may be surrendering our own due diligence to non-experts, pseudo-experts, or merely those in positions of authority. An individual exercising “Ready, aim, fire” can be expected to produce better results than a herd practicing “Ready, fire, aim.”

Statman points out the average investor--over time--can rarely beat the market, which gets back to the idea of [reverting to the mean](#): you may outperform for a while, but then your

performance tends to be pulled back to the center of mass as new competitors get on board and the weak are weeded out. Accordingly, he recommends small investors put their money in index funds that provide good enough--average, if not spectacular returns--while avoiding catastrophic losses. Still, large institutional investors are not immune from these same mistakes, as made manifest in the market meltdowns of 2008. Then, grossly inaccurate risk assessment models enabled by high-speed programmed trading led to a toxic witch's brew of financial failure that 'just couldn't occur.'

So even though the future is inherently unknowable, that doesn't mean there aren't reasonable and prudent actions we can take to work to improve our national security. An important first step is to know your own biases, intellectual shortcuts, experiential gaps, and unexamined assumptions as you ponder your own place in the national security environment. In the mean time my friends, invest wisely.

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